No. 11116

# In the United States Circuit Court of Appeals

## For the Ninth Circuit

GEORGE M. McBRIDE, Trustee in Bankruptcy of Western Bond and Mortgage Company, an Oregon Corporation, Bankrupt,

*Appellant,*

vs.

C. H. FARRINGTON,

*Appellee.*

## BRIEF OF APPELLANT

Upon Appeal from the District Court of the United States for the District of Oregon.



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### STATEMENT OF THE CASE

A petition in bankruptcy was filed against the Western Bond and Mortgage Company on November 25, 1931 on which it was thereafter adjudged bankrupt. On December 4, 1934 George M. McBride, appellant here, was elected Trutsee and thereupon duly qualified.

On October 2, 1943 the Trustee filed an action based on fraudulent appropriation by C. H. Farrington, the president of the bankrupt corporation, of assets of over half million dollars. This action is the subject of the appeal.

The issue was raised by Farrington, the appellee, that the suit was barred by the statute of limitations in that it was not brought by the Trustee within two years from the time the fraud should have been discovered.

The Oregon Statute limits the time when a suit may be instituted for fraud to two years from the discovery.

## I. THE FACTS AS TO FRAUD, AND THE COVERING UP OF SAME.

C. H. Farrington, appellee, was president of the bankrupt corporation and the owner of substantially all of its common and controlling stock. In December, 1930, less than a year prior to the bankruptcy, Farrington concocted a scheme, which he carried out, whereby assets of the corporation of large value was appropriated by him; and the corporation was denuded of these assets and received nothing of value in their stead. The method of manipulation whereby such scheme was carried out was the formation of a corporation, the transferring of assets to such cor-

poration and to other corporations controlled by Farrington and the exchanging of stock for property, with the result that ultimately, and through intermediate transfers, Farrington had acquired the property of the corporation paying nothing of real value therefor, and the corporation was left without such assets or other thing of value. The consummation of these fraudulent transfers were handled so that their real purport was not discoverable from the books and records of the bankrupt corporation. The method of handling the transactions were formulated and designed to prevent discovery.

The first of the two claims set forth in the complaint, for example, was handled in the following manner:

Farrington, the president and controller of the stock of the bankrupt, caused a corporation to be formed without authorization, which he called the Western *Guaranty* Co., with $5000 par value stock; and likewise without authorization, he caused the bankrupt corporation to subscribe for all of such stock, transferring to the Guaranty Co. assets of a value of $322,014.35 for such stock of a $5000 par value. Thereupon Farrington, through a dummy corporation owned by him personally, purchased for his worthless stock in the bankrupt corporation certain worthless stocks, notes and accounts, and simultaneously purchased from the bankrupt corporation the Guaranty Company's stock (representing its $322,-

014.35 of assets) for these worthless securities. These transactions, however, in so far as they were recorded on the books or records of the bankrupt, showed merely a transfer of assets ($322,014.35 of accounts and notes for Guaranty Co. stock) to a wholly owned subsidiary and then the transfer of that stock for property of equal value. Farrington's connection with these matters were not disclosed by the books.

The second of the two claims set forth in the complaint was handled in the following manner:

The bankrupt owned 40,000 shares of the Consolidated Credit Corporation's stock of a total value of $120,000. Without any authority Farrington caused this stock to be transferred out of the bankrupt corporation to a person or persons unknown, in consideration of all the capital stock of the Keystone Finance Company, purporting to be of equal value. As a matter of fact, the stock of the Keystone Finance Company was then already owned by the bankrupt. However, its ownership of such stock was not disclosed by the books of the bankrupt.

## II. THE FACTS AS TO THE DISCOVERY.

It must be admitted that the Trustee did not discover the frauds set forth until a few months prior to the filing of the suit. Certainly if that fact is not conceded it is apparent that the evidence does not disclose any such actual discovery on the part of the

Trustee. On the contrary, the Trustee's testimony (Tr. pp. 95, 96) is a positive affirmation of the non-discovery of the facts.

## III. THE FACTS CONCERNING FAILURE TO DISCOVER.

### (a) Western Guaranty Co. Stock Appropriation (The First Claim).

The Trustee was appointed in December, 1934. Early in 1935 the Trustee, upon authority of an order of the Referee (Exhibit 104, Tr. p. 120) employed John R. Latourette as attorney to represent him. Mr. Latourette acted as attorney for the Trustee for about a year. In 1936 the firm of Teiser & Keller was substituted for him as attorney for the Trustee. (Exhibit 106). During the year that the Trustee was represented by Mr. Latourette, according to Mr. Latourette (defendant's own witness):

> "Well we investigated everybody we could from the time I was there, trying to get some assets. We investigated Mr. Farrington, the Bank of California—we had two accountants from the Corporation Department that were in my office a number of times and were in Mr. McBride's office. I was down there. I went through as many records as I could find that pertained to any of the people that were involved in the thing.
>
> I think I was in there for about a year and we concluded that we had a case against the Bank of California, and I prepared a complaint, a rough draft, which I was waiting to sumbit to

> Mr. Moody for his approval. I never got to see Mr. Moody or never prepared the complaint in its final form during the time I was representing the Trustee, I think about a year or more." (Tr. 208-210).

When he was asked what he discovered about any lawsuits which had been brought concerning the Western Bond and Mortgage Company and Mr. Farrington in 1931 and as to any discussion he had with the Trustee concerning them he answered:

> "I don't know. I can't say definitely that he had any discussion with Mr. McBride about the particular suits. I know they were trying—we were trying to find out about the whole thing, about Mr. Farrington, as well as all of the others who had been involved in the thing, but as to any particular conversation regarding those things after these, so many years, I do not recall.
>
> "Mr. Moody told them (the State Department's auditors) to cooperate with us and they were available to us at all times, and they had been through the records pretty thoroughly. It seems to me that they had made a general report —I might be mistaken about that though." (Tr. 208-210).

Upon the substitution of the present attorneys for Mr. Latourette these attorneys continued the investigation and discovered that notwithstanding nothing had been done about it the Bank of California transaction "stuck out like a sore thumb". (Tr. p. 213). Subsequently suit was instituted and recovery had against that Bank. From further investigations made by the attorneys another matter developed, viz., a

matter concerning transaction with Dr. Besson and Mr. Brown, and this matter was litigated (Tr. p. 213). Another situation also arose and was investigated, viz., transfer of property in Corvallis (Tr. p. 213) though no recovery was made as to the latter.

Mr. McBride during the period of his trusteeship, particularly in the first year thereof, had the assistance of the Assistant Attorney General of Oregon, Mr. Ralph E. Moody, and certain auditors from the Corporation Commissioner of the State of Oregon, and both Mr. McBride and these auditors made investigations, but it is quite apparent that no information was obtained either by Mr. Moody or the auditors concerning the facts set forth in the Trustee's claims. (Tr. p. 104 and pp. 193, 194).

The Trustee himself it appears was not an accountant, though he had some knowledge of bookkeeping, and he himself examined the books (Tr. p. 108) and found nothing irregular. (Tr. p. 96).

As a preliminary to bringing the proceedings against the Bank of California, the Trustee in 1936 employed Rudolph Erickson, a certified public accountant (Tr. p. 122) for the purpose of making a general investigation of the books, (Tr. p. 168) but particularly in reference to matters connected with the bankrupt's transactions with the Bank of California. (Tr. pp. 175, 176). Mr. Erickson found that the books on their face showed no improprieties in regard to transactions concerning the transfer of the

Western Guaranty Co.'s stock (Tr. p. 141). In June of 1943 the accountant first discovered the questionable character of this transaction. (Tr. pp. 144-145 and p. 148).

The occasion resulting in the discovery arose under the following circumstances:

In 1935 the United States Government filed a claim for additional income taxes claimed to be due for the year 1930 (Tr. p. 91). Shortly after the filing of the claim the Trustee called on the then Referee, Mr. A. M. Cannon for the purpose of discussing with him the making of objections at that time to the Government's claim. (Tr. p. 91). He was told by the Referee that there was no purpose to be served by filing at that time objections to the Government's claim since the estate had no money in it with which to pay any portion of the claim even if it were allowed, and the matter would therefore be merely academic at least until such time as property or funds should come into the estate out of which the claim could be paid. (Tr. p. 92). So the Referee instructed the Trustee, until further advice, not to file objections to the claim (Tr. p. 92). In 1943 the first money or property came into the estate over and above the amount deemed necessary to pay the expenses of administration. (Tr. p. 93). At that time, pursuant to instructions given by the Referee, who was then Mr. Estes Snedecor, it was determined to investigate the claim of the Government for the purpose of determining what, if any, objection should be filed to such claim.

(Tr. p. 93). The claim of the Government was for over $50,000 and, with interest, amounted to approximately $65,000. (Tr. p. 120). With the approval of the Referee, the Trustee re-employed certified public accountant Erickson (Tr. p. 87 and pp. 176, 177), this time for the purpose of making an examination in the endeavor to discover data on which to file objections to the tax claim. (Tr. p. 94). Concomitant with the employment of Erickson the Trustee attempted to obtain, upon Erickson's suggestion, a copy of the original report of the revenue agent upon which the additional assessment of 1930 income tax was based. (Tr. p. 94). The Trustee had endeavored to obtained a copy of this report prior to the time he had the discussion with Mr. Cannon, the former referee, but in the light of Mr. Cannon's determination that the tax claim need not then be contested, the Trustee made no further effort to obtain a copy of the report until 1934 (Tr. 119, 120) when the contest over the claim became imminent. There was no copy to be found in the records of the Western Bond and Mortgage Co. (Tr. p. 146) and the Trustee had never seen a copy of it (p. 119) until a short time before the present suit was brought. A copy of the report (Exhibit 59) was ultimately obtained from the Internal Revenue Department in 1943 (Tr. p. 146) and such copy was turned over by the Trustee to the Certified Public Accountant so that the accountant could have before him the basis on which the additional tax was assessed. The report not only showed such basis but

also indicated certain improprieties in connection with the Western Guaranty stock transfer. By reason of the lead thus furnished the certified public accountant brought the matter to the attention of the Trustee and was asked to make a thorough investigation and to report on the situation. (Tr. p. 147). The investigation thus made resulted in a report from which the facts set forth in the complaint were first discovered. (Tr. p. 96). When the accountant's report was made to the Trustee the Trustee made immediate additional efforts to confirm the facts reported. This he did, by causing the accountant and his attorney to make two trips to Seattle and Everett, Washington, and to confer with those having information there (Tr. p. 151) and by causing examinations to be made of various parties under the provision of Sec. 21(a) of the Bankruptcy Act. (Tr. p. 95). Upon thus verifying the data contained in the report of the certified public accounts, the Trustee filed a suit which is the subject of this appeal.

### (b) Consolidated Credit Corporation Stock Transfer (The Second Claim).

The accountant ascertained the facts in the Consolidated Credit stock manipulation in connection with the seeking of valid offsets to the alleged profits asserted by the Government in the maintenance of its claim for additional taxes. Naturally the Government did base its claim on the Revenue Agent's re-

port and naturally the accountant did need that report in his examination in connection with the Trustee's opposition to the Government's claim. But until the claim of the Government was being pressed by it in 1943 and until the Trustee was required to prepare for trial in opposition to such claim there was no need for an inspection of the Government Agent's Report, nor was there any earlier need to delve into the claim of the Government in an effort to defeat the tax. Let it be said in this connection that the Revenue Agent's report made no mention whatsoever of the Consolidated Credit Corporation's stock manipulation. It was discovered by the certified public accountant in the following manner:

Items of profit reported by the Revenue Agent, as well as other transactions shown by the Company's books were scrutinized by the accountant not only for the year 1930 but for the year 1929. It was necessary to examine the 1929 transactions since the Company had the right of a deduction in 1930 for carry-over of a 1929 loss. In the Revenue Agent's report for the year 1930 (Schedule A of its Exhibit 5-A) the Revenue Agent made an adjustment increasing the taxable income for 1930 through a decreasing of the allowable deduction for the loss carry-over for 1929. In the accountant's research for available offset he had to examine many and varied transactions found on the Company's books. Most of the transactions, upon examination, were deemed to be of no available use either for the purpose of offsetting the additional

profits asserted by the Government Agent, or the deductible losses negated by the Agent, but some were found which seemed to be available. However, even as to those which seemed to be available some upon further search were found not to be and others were found to be. Among the latter there was discovered by the accountant a sale appearing on the books of 40,000 shares of stock of Consolidated Credit Corporation made in 1929 for 1500 shares of the Keystone Finance Company's stock. (Tr. p. 178). In considering the acquisition of the 1500 shares of the Keystone Finance Co. by the Western Bond and Mortgage Co. the accountant endeavored to trace from whom those shares came. He went to the minute books of the Keystone Finance Co. and found that the shares were subscribed for in the name of one Tapfer and one Snodgrass (Tr. p. 181), in consideration of the transfer by Tapfer and Snodgrass of the property known as the Russell Ranch in Crook County, Oregon. (Tr. p. 181).

Now it so happened that the accountant at the time of this examination in 1943 had in his possession an abstract of title to the Russell Ranch, since a client of his had just purchased such ranch from the Trustee. (Tr. p. 147 and 181). On the inspection of the abstract of title he ascertained that Tapfer and Snodgrass never owned this ranch, but that it was owned at that time, as well as prior and subsequently, by the Russell Land and Livestock Co., which had found to be a wholly owned subsidiary of the Western

Bond and Mortgage Company. (Tr. p. 148 and 181). Thus discovery was first made by the accountant (Tr. p. 148) that in 1929 the Western Bond and Mortgage Co. had parted with 40,000 shares of the Consolidated Credit Corporation's stock, which it owned, for 1500 shares of the Keystone Finance Co., which at that time it also owned (Tr. p. 178) and that therefore the bankrupt had parted with $120,000 worth of property and receiving nothing therefor, it had sustained a loss in 1929 of $120,000 on this purported transaction. Such a loss was offsettable for tax purposes against the Company's 1930 gain. This discovery having brought to the knowledge of the accountant facts which indicated that the Western Bond and Mortgage Company had parted with substantial assets for which it had received nothing, he promptly reported same to the Trustee, who promptly thereafter instituted the suit which is the subject of this appeal.

## IV. THE EXCUSE OR LACK OF EXCUSE FOR FAILURE TO DISCOVER.

### (a) Farrington's Contentions.

The contention is made by Farrington that the Trustee was negligent in his search for facts and that—as an ordinarily prudent man—he should have discovered Farrington's fraud earlier.

Farrington asserts three reasons why the Trustee's failure to discover his frauds, barred this suit:

First, he asserts that newspaper articles (Exhibit 162) had come to the knowledge of the Trustee and his attorney while they were taking testimony in the proceedinys against the Bank of California and against Besson and Brown in November, 1936, and that these articles contained references to a suit against Farrington, the Western Bond and Mortgage Company, and others, and to two suits against the Western Bond and Mortgage Company. Such suits it is claimed by him were based on fraud, and that therefore had the Trustee searched into the records of these cases they would have led the trustee to further investigate, from which investigation, it is charged, the facts of Farrington's misdeeds as detailed in the present action would have been ascertained.

Second, the contention is made by Farrington that the Trustee was derelict in his failure to procure earlier than he did the Revenue Agent's Report (Ex. 59) on the additional tax liability of the bankrupt corporation for the year 1930. Had he procured this agent's report sooner, it is asserted by Farrington, the Trustee would at the time of such procurement been charged with a duty further to investigate and would have earlier been enabled to discover Farrington's fraud.

Third, Farrington further charges that the Trustee should have earlier caused to be made a complete examination of the books and records of the bankrupt.

**(b) The Trustee's Position.**

The Trustee maintains that his activities in connection with the discovery of Farrington's fraud was those of an ordinarily prudent man under the circumstances. He insists that, considering the method adopted by Farrington in manipulating the books to disguise the real purport of transactions and thus to prevent discovery, he discovered the fraud at the first occasion indicating its whereabouts.

The newspaper articles (Exhibit 162) had they sent him to the records of the cases therein referred to, he affirms, would have disclosed only one case against Farrington, and that would have further disclosed that that case had been dismissed by the one who had brought it and at his substantial taxed costs. The cases against the Western Bond and Mortgage Co. and others would have disclosed nothing in connection with the incidents here under review. No dereliction, therefore, he avers, could possibly have been predicated upon a failure to explore in this regard.

As to the asserted failure to obtain a copy of the Revenue Agent's report on 1930 taxes—(Exhibit 59) the only apparent reason for the obtaining of such report would have been in an effort to defeat, in whole or in part, the additional tax assessment based thereon. The Trustee insists he obtained this report immediately the defeating of the tax became an issue.

Of course a complete and thorough examination and audit by certified public accountants, in addition to the examination and report of the two state auditors, could have been made at the inception of the trusteeship or at any time thereafter. Whether such audit would have uncovered what was uncovered by the Revenue Agent, who had access not only to books and records of the bankrupt but to those of all other corporations, firms and individuals, is unknown. However, there was no moneys available with which the Trustee could pay for same. Until the payment of the Bank of California judgment in 1943 never was there more than $2500 on hand at any year's beginning or end (Exhibit 111) and the average amount was much less.[1] This money had been ear-marked, in effect to defray the costs and expenses of carrying on the Bank of California litigation—the one which the Trustee's attorney stated "stuck out like a sore thumb". Until that litigation was brought to a successful conclusion no additional money was brought into the estate. (Exhibit 111).

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[1]An analysis of the financial report which is in evidence (Exhibit 111) shows that on December 31, 1934 there was no balance. On the same date in 1935 there was a balance of

| | |
|---|---|
| | $ 439.30 |
| 1936 | 237.03 |
| 1937 | 228.10 |
| 1938 | 2,421.61 |
| 1939 | 2,096.36 |
| 1940 | 1,935.06 |
| 1941 | 1,829.31 |
| 1942 | 1,345.25 |
| 1943 | 1,445.25 |

Hind-sight, ex post facto wisdom, clairvoyance, is not a required attribute of a trustee, and the lack of it is not to be used against him by one whose fraud was not earlier discovered.

It is further maintained that even were the Trustee negligent, his dereliction should not be callipered against the positive fraud of Farrington, to the detriment of innocent creditors who were injured by such frauds, and who were powerless to appraise or command the sleuthing faculties of the Trustee.

Moreover, the Trustee stresses the fact that there was no evidence adduced that any of the thousand creditors, even those who instituted suits against the corporation or against Farrington, ever call to his attention the frauds here presented.

## JURISDICTION

The District Court had jurisdiction of the cause by virtue of Sec. 67(e) of the Bankruptcy Act (11 U.S.C., Sec. 107 (e) ), as amended, which provides that courts of bankruptcy as well as state courts shall have jurisdiction of such actions as here brought. Like jurisdiction is given under Sec. 70(e)(3) of the Act, (11 U.S.C.A. Sec. 110 (e)(3)—1945 Pocket Part).

This Circuit Court of Appeals has jurisdiction on appeal by virtue of Sec. 24(a) of the Bankruptcy Act, as amended (11 (U.S.C.A. Sec. 47(a)—1945 Pocket Part).

## THE ISSUES

I. Does the Bankruptcy Act of 1898 (prior to Amendment by the Chandler Act, apply?

II. If so, does the Oregon Statute of Limitations (2 years from discovery,) or Sec.(d) of the Bankruptcy Act (2 years from the closing of the estate) apply?

III. If the Applicable Statute is the Oregon Statute of Limitations, was the action brought within the time prescribed by that Statute?

IV. Was the Trustee guilty of laches?

## SPECIFICATIONS OF ERRORS

I. The Court erred in determining that the Oregon Statute was the Applicable Statute.

II. The Court erred in determining that the time prescribed by the Oregon Statute, (if that Statute was the applicable one), had run before the institution of the action,

(a) In that it held that the Trustee had not brought the action within two years from discovery.

(b) In that it held that the information which came to the Trustee charged him with the duty to pursue it.

(c) In that it held that such information, if pursued, would have resulted in discovery at a time more than two years prior to the institution of the action here.

III. The Court erred in holding that the Trustee was guilty of laches.

## SYNOPSIS OF THE ARGUMENT

I. The Bankruptcy Act of 1898 (prior to Chandler Amendment) applies, and the limitation of Sec. 11(d) keeps the action alive until two years after closing of estate.

II. If the Bankruptcy Act, as amended by the Chandler Act, applies, or if the Oregon Statute is the applicable statute, the action is not barred, because:

(a) The action was brought within two years of the discovery of the fraud.

(b) The Trustee had no information charging him with the duty of further inquiry.

(1) Knowledge of the newspaper articles was not such information.

(2) Knowledge of the availability of the books and records of the bankrupt was not such information.

(3) Knowledge of the existence of a Reve-

nue Agent's Report recommending additional assessment for 1930 tax was not such information.

(c) But if Trustee were chargeable with duty of further inquiry, investigation in that one debatable instance, would not have resulted in discovery.

(d) Discovery, even if made, would have related only to Trustee's first claim (the Guaranty Company stock transaction).

(e) The negligence of the Trustee (if there was such) is not to be nicely balanced against the fraud of a defendant who fraudulently profited at the expense of innocent creditors having no authority over the Trustee nor any power to direct his activities.

III. There were no laches.

IV. Some comments on District Judge's Opinion.

## APPLICABLE STATUTES

Sec. 11(d) of the Bankruptcy Act of 1898 (Title 11 U.S.C.A., Sec. 29 (d) ) not amended by the Chandler Act, reads as follows:

> "Suits shall not be brought by or against the Trustee of a bankrupt estate subsequent to two years after the estate has been closed."

Sec. 11(e) of the Bankruptcy Act of 1898, as amended by the Chandler Act of 1938 (Title 11 U.S.C.A., Sec. 29(e) Pocket Part) reads as follows:

> "A receiver or trustee may, within two years subsequent to the date of adjudication, or within such further period of time as the Federal or State law may permit, institute proceedings in behalf of the estate upon any claim against which the period of limitations fixed by Federal or State law has not expired at the time of the filing of the petition in bankruptcy."

The Oregon Statute, Sec. 1-206, O.C.L.A., reads as follows:

> "Within two years—An action for assault, battery, false imprisonment, for criminal conversation, or for any injury to the person or rights of another, not arising on contract, and not herein specifically enumerated, provided that in an action at law based upon fraud or deceit, the limitation shall be deemed to commence only from the discovery of the fraud or deceit."

The Oregon Statute, Sec. 9-103, O.C.L.A., reads as follows:

> "A suit shall only be commenced within the time limited to commence an action as provided in Chap. 2, of Title 1 of this Code. . . . In a suit upon a new promise, fraud or mistake, the limitation shall only be deemed to commence from the making of the new promise or the discovery of the fraud or mistake. . . ."

## ARGUMENT

### I. THE BANKRUPTCY ACT OF 1898, PRIOR TO THE CHANDLER AMENDMENT IN 1938, IS THE APPLICABLE LAW.

Sec. 11(d) of the Bankruptcy Act of 1898 (Title 11 U.S.C.A., Sec. 29(d) ), unamended by the Chandler Act, provides that the Trustee has two years after an estate is closed before he is required to bring suit. At the time of the filing of the petition in the matter of the Western Bond and Mortgage Company, Bankrupt, and at the time of the appointment of the Trustee in 1934, the Bankrupt Act of 1898 unamended, was in effect and it is maintained that under the Act the Trustee has two years after the closing of the estate in which to bring suits of action. In 1938 the Bankruptcy Act was amended by the Chandler Act, which provided that the Trustee should be required to bring suit within two years of the date of adjudication, or within the time limited by the Federal or State statutes. Assuming, but by no means admitting, that the Trustee should have discovered the fraud as claimed by the defendant not later than July 1, 1935 (Pretrial Order, Tr. p. 55), the Chandler Act, if it be given a retroactive effect, would have on its effective date abrogated the right of the Trustee to bring this action, notwithstanding the fact that up to that moment the Trustee would have had until two years after the closing of the estate to do so. But we maintain that

the Chandler Act had no such retroactive effect. It acted prospectively only, save as to matters of procedure, and then only if the Court determines it is practical (See *Hastings v. H. M. Byllesby & Co.*, (N.Y.) 57 N.E. (2d) 737, 739-741, and *Pittman v. Bump*, 5 Ore. 17, 20. We refrain from quoting from or discussing these cases at this time, and likewise refrain from further arguing this phase. We so refrain because, first, we do not believe it will be necessary to determine this appeal on this point, and secondly, because the previous decisions by this Circuit Court of Appeals,[1] contrary to decisions in other circuits,[2] seem to indicate that, notwithstanding, the Bankruptcy Act prior to the Chandler Amendment be the applicable statute, still in a case like this, not based on preference, this Court would probably hold that the State Statute would still apply. We believe this Court has not gone so far, and that we could convince the Court that even under decisions in this circuit, Sec. 11(d) of the Bankruptcy Act prior to the Chandler Amendment would not bar this suit until two years after the closing of the estate. We do not waive the point, but we shall not further discuss it.

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[1] *Davis v. Willey*, 273 Fed. 397; *Meikle v. Drain*, 69 Fed. 2nd, 290.

[2] *Isaacs v. Neece*, 75 Fed. 2nd, 566; *Fuller v. Rock* (Ohio) 180 N.E. 367, 20 A.B.R. (N.S.) 655; *Sproul v. Gambone*, 34 Fed. Sup. 441, 443. In re *Handy Andy Stores* of L.A., 41 Fed. 2nd 98, 105; *Nairn v. McCarthy*, 120 Fed. 2nd, 910, 912.

### II. (a) Action Brought Within Two Years of the Discovery.

There is direct testimony to the effect that the discovery of the fraud occurred only within a month or two before the bringing of this action (Tr. p. 95, 96) and there is no testimony whatsoever of an earlier discovery.

### II. (b) The Trustee Had No Information Charging Him With the Duty of Further Inquiry.

We recognize the doctrine that where a party has the available means of discovery and is put on notice of such a character that it becomes his duty to make inquiry, then whether or not he makes such inquiry he is chargeable with the facts that such inquiry would ordinarily develop. We say we recognize this doctrine and its existence in ordinary cases, but we deny its impact in cases where the defrauding party has through secrecy and design made it hopeless for the fraud to be discovered. But this phase will be covered under a separate heading later. Accepting the doctrine, however, in its general aspect, it is maintained that the Trustee had no information of sufficient character to charge him with the duty of inquiry, nor any information which would have led him to believe that discovery would have followed inquiry. This statement is a legal conclusion from the evidence,

and of course such conclusion is as capable of being drawn by this Appellate Court as by the District Judge. What, then, was the information which came to the Trustee to charge him with a duty of further inquiry?

**1. Newspaper Articles Not Such Information.**

The testimony at the most shows that the Trustee had the means available of obtaining information concerning certain suits brought by certain bondholders against the Western Bond and Mortgage Co. (Ex. 74 and 86) and by a bondholder against Farrington and others (Ex. 62). The means thus available to him was indicated by certain newspaper clippings included, among many documents, in a large credit file which credit file was introduced in the proceeding brought by the Trustee against the Bank of California (Ex. 162). These newspaper clippings refer to several suits, but in themselves made no reference to the charges which is the subject of this suit. The testimony is completely lacking to the effect that any of the plaintiffs in these several suits ever attempted to bring any information to the Trustee or to call to his attention any data concerning the frauds here alleged, or for that matter, any frauds. Was the Trustee, therefore, under such circumstances, chargeable with the duty to make inquiry, assuming for the nonce (which we deny) that the inquiry would have resulted in discovery. (Of this more later.) As was said by

this Court in the case of *Anglo California Bank v. Lazard,* 106 F. (2d) 693, 704:

> "Appellants contend that the means of knowledge is the equivalent of knowledge. Appellees concede that appellees, or the owners, had the means of discovering the inadequacy of the selling price, but it is of no consequence that the facts disclosing fraud could have been discovered had an investigation been undertaken sooner. Appellees, or the owners, were not bound to make an investigation until they had knowledge of the facts of such a character as to put them upon a duty of inquiry."

**2. Existence of the Bankrupt's Books and Records.**

The doctrine of the case of *Anglo California National Bank v. Lazard* also applies to the claim made by Farrington that the books and records of the bankrupt corporation were available and that discovery could have been made therefrom, notwithstanding his camouflaging of the books to prevent such a discovery.

It is perhaps true that had a thorough and complete examination been undertaken, at great cost, of the books and records of the Western Bond and Mortgage Co., the frauds may have been discovered, although that is somewhat of an assumption, for the books of other companies and individuals might have had to be scrutinized before such frauds could have been uncovered. But the question here is: was the Trustee under a duty to expend the estate's meager funds already committed for other purposes,

(viz., the carrying on of the Bank of California litigation), or to go in debt personally, or to expend moneys of his own in order to make an investigation, the results of which were uncertain? The Court must place itself, in making the conclusions, in the position the Trustee was in, at that time. The litigation against the Bank of California had begun and was being hotly contested by the Bank, who had adequate means to contest it. The Trustee who had accumulated from one to two thousand dollars in the estate (Exhibit 111—See Tabulation, p. 16 this Brief) realized that even if the case were won, an appeal would undoubtedly be taken, which might not stop at the Circuit Court of Appeals. The cost for transcribing testimony and records, for services of a certified public accountant, for travel in procuring testimony, for printing Transcript and briefs, would in all likelihood take all available funds, notwithstanding that this was a case in which the facts were pretty well suspected or discovered. We urge, with a feeling of sureness, that the Trustee was under no duty under the circumstances to indulge in any such extravagances, particularly since State accountants from the Attorney General's office had made an examination of the books and had reported to the Trustee (Tr. pp. 108-109, 192-193, 209-210), in which examination or report the frauds here at issue were not indicated (Tr. pp. 121-122, 209-210).

### 3. Revenue Agent's Report Concerning Additional Assessment of 1930 Taxes.

It is also claimed by Farrington that the Trustee had the available means of discovery of his fraudulent acts in a revenue agent's report concerning the assessment of additional taxes for the year 1930. True, the Trustee knew that a report was in existence, although it had been removed from the records of the bankrupt (Tr. 146). The availability of such report to the Trustee through his ability to obtain a copy of it from the Department of Internal Revenue, it is claimed by Farrington, would have brought knowledge of the frauds here invoked. But we maintain with assurance that the fact that the Trustee may have known of the existence of a report containing recommendation for assessment of additional taxes for the year 1930 certainly did not charge him with the duty of obtaining this report where there was no intimation, inference or knowledge that such report contained any indications of fraud whatsoever.

Such reports of agents rarely indicate fraudulent transaction. Usually they contain the agent's interpretation of the regulations and the law as applied to the facts justifying a larger tax than returned by the taxpayer. They are usually concerned with matter of accounting. Why should the Trustee, we ask, have suspected that this report should have contained indications of fraud? Why should the Trustee expect the unusual?

We therefore maintain that the means in this connection of information available to the Trustee were not such as to charge him with the duty to seek out this report at that time.

### II. (c) Would Inquiry, If Pursued, Have Resulted in Discovery.

In only one instance of those just discussed is it even debatable that the Trustee owed a duty to investigate.

We have shown conclusively, we believe, that there was no such duty to initiate an extensive and costly examination of the books and records of the bankrupt, after a thorough examination by State auditors had been completed without results (Tr. p. 210), and after the Trustee, with some knowledge of bookkeeping, had gone over the books himself, also without results. We have also shown, we believe, with like conclusiveness, that no such duty existed, until need for it was indicated, to obtain a copy of the Revenue Agent's Report concerning 1930 taxes, for the Trustee had no intimation of the contents of such report, nor any reasonable cause to believe that such report would charge fraud (Tr. p. 120). When the duty arose to obtain such report in order to contest the tax claim of the Government based thereon the Trustee promptly obtained it (Tr. pp. 91-95, 120).

The only situation, therefore, open at all to de-

bate is the situation which arose when the newspaper clippings came to the attention of the Trustee in another connection and in other proceedings. Assuming therefore, for the sake of argument only, (while vehemently denying it) that the duty of inquiry arose upon the Trustee's awareness of the newspaper clippings contained in the Bank of California credit file, let us suppose therefore that investigation followed. Of course the only and obvious investigation indicated was of the court records of the cases referred to in the clippings. What would have been the reasonable result of such investigation? The Trustee would have discovered that there were three suits referred to in the clippings. Two of them were not against Farrington (Exhibits 74 and 77). The pleadings in neither of these cases even remotely referred to the frauds here alleged. Certainly after an inspection by the Trustee of such records, he neither would nor should have gone further. Therefore these two cases are out.

Now as to the other case, that of John Brockie v. Western Bond and Mortgage Company, C. H. Farrington et al, (Exhibit 62) instituted in the District Court of the United States for the District of Oregon in March, 1933: In that case had the Trustee gone to the records he would have discovered that the suit had been dismissed by John Brockie shortly after it had been brought (Exhibits 68 to 71) over the protest of Farrington, and at Brockie's cost (including a substantial special master's fee) which costs the Court

directed to be paid before dismissal. Irrespective of what the charges were in the complaint in that case, we are positive that we are justified in stating that the Trustee, as an ordinarily prudent man, would have ceased from further inquiry upon ascertaining the fact that the cause had been dismissed. Any normal person, however prudent, would be justified in immediately concluding that a suit dismissed at the motion of the party who brought it and at his cost over opposition of the defendants, was based on charges which to say the least were unfounded.

We maintain therefore that even were the Trustee under the duty to further investigate in this connection, such investigation would not have resulted in discovery of the frauds here assigned. Of course the Trustee is chargeable only with discovery of such facts as ordinarily would result from the investigation.

### II. (d) Discovery, If Made, Would Have Related Only to First Claim.

Let us continue further. Should this Court be of the opinion that the Trustee was under the duty to inquire and examine into the matters further in connection with the suits brought by others against the corporation and the suit brought against Farrington, what would the Trustee have discovered if such inquiry had been pursued? The suit or suits against

the corporation indicated in no way the frauds here charge. (See Exhibits 74 and 86). The Brockie suit against Farrington (Exhibit 62) indicated nothing whatsoever concerning the Consolidated Credit Corporation stock manipulation (the second claim). Consequently, inquiry induced by the newspaper articles, if followed through irrespective of reasonable cause to desist (the dismisal of the suit) could in no way have resulted in discovery of the fraud connected with the Consolidated Credit Corporation stock manipulations (the second claim).

Moverover, no inquiry whatsoever could have resulted in a discovery of the frauds charged in the second claim, in so far as the Revenue Agent' Report was concerned, for that report made no reference whatsoever of the Consolidated Credit Corporation stock manipulation. Thus, however soon or late the Trustee may have obtained the Agent's Report would not have affected discovery or failure to discover the frauds connected with that manipulation. It will be recalled that such frauds were discovered by the accountant upon probing for possible losses to offset asserted gains in connection with a contest of the Government's claim for taxes, which contest did not arise until 1943. Information concerning these frauds did not come from the Agent's Report.

We have heretofore covered the question of the Trustee's duty in regard to an exhaustive examination of the books of the bankrupt taken in considera-

tion the financial situation of the estate. We shall not do so again.

### II. (e) Balancing Trustee's Faults Against Farrington's Frauds.

We are not unmindful of the doctrine heretofore referred to that where there is means of information available, and there comes to one charged with the duty of inquiry relevant facts, a failure to pursue those facts charges him who has the duty to inquire, with the knowledge discoverable through such inquiry. In relation to statute of limitations, this doctrine is expressed in *Fleishhacker v. Blum,* (C.C.A. 9th) 109 F. (2d), 543, 548, as follows:

> "The word 'discovery', as used in the statute, means actual knowledge, or knowledge of facts which, in the exercise of diligence, would have led to an actual discovery of the fraud."

The doctrine, however, is modified when the fraud alleged is of a secret nature and designedly covered up by the party charged. And so this Court, in the case of *Pickens v. Merriam,* 242 Fed. 363, 368, held that when fraud which is the foundation of a suit has been concealed, or is of such a character as to conceal itself, the statute does not begin to run until the fraud is discovered by the party suing.

But here there is a much wider principle involved. A Trustee, it is true, represents the creditors. He is elected by a majority of them who happen to be pres-

ent at the first meeting of creditors. After the Trustee's election creditors have no control of supervision over him. He does not report to them, and the creditors only official contact with him is through the Referee or the Court. They cannot command nor compel.

So with this in mind, what happens to creditors who have been defrauded by a officer of a bankrupt concern where the Trustee whom they can neither command nor compel fails to possess the sleuthing qualities which one with *post facto* wisdom may think a prudent man should possess? Assuming that a Trustee is ignorant or careless, or even reckless, or corrupt, should the fraudulent denuder of a corporation's assets profit at the expense of innocent creditors because of a trustee's failure to act or because of a trustee's reckless or even corrupt action? Should a trustee's negligence, carelessness or recklessness affecting innocent creditors, be weighed in the scales and be nicely balanced as against a defrauder, by whose cleverness a trustee may be lulled into carelessnes? The answer suggests itself. Perhaps if a trustee were acting for himself or as the agent of another, who had complete control and supervision over him, his inaction or carelessness or negligence might result in the barring of an action against the defrauder. However, we pose the question whether under the circumstances here existing the creditors should be penalized by a meticulous balancing of faults between the trustee and the defrauder; the

balancing of carelessness or negligence, if there were such, as against secretive and camouflage fraud? We feel justified in urging the court not to permit such a doctrine to be established in this circuit.

## III. THERE WERE NO LACHES.

If the Trustee was under no duty to pursue inquiry, or if he was under such duty and the inquiry reasonably expected of him would not have resulted in discovery, or if, as lastly stated, his mere carelessness is not to be weighed against the fraud of the defendant, then this action is not barred. Assuming, therefore, that the Court will come to such conclusion. there is then no room for a discussion of laches. If the Court comes to a contrary conclusion, thus barring the action, then, of course, laches need not be discussed here.

In Sedlak v. Sedlak, 14 Or. 540, 541, Justice Lord said:

> "The general rule, without doubt, is, that no lapse of time or delay in bringing suit will be a bar to the remedy in equity, provided the injured party, during the interval was ignorant of fraud. But the ignorance of such party must not have been negligent; for it, by reasonable diligence, the fraud could have been discovered, or ought to have been known, he will be deemed guilty of laches, or of acquiescence, and equity will refuse to interfere."

In other words, if the action is barred laches becomes an academic question. If the action is not

barred the laches would not bar it under the facts in this case, and we feel no further discussion is necessary in that respect.

## IV. COMMENTS ON DISTRICT JUDGE'S OPINION.

We are loath to be critical of so eminent and able a judge as Judge Fee, but the case at bar does not seem to have had his usual analytical attention. We feel, therefore, free to make some comments upon his opinion, and to point out what is believed to be his erroneous conclusions.

He praises, in one breath, the Trustee and his attorneys for their "years of unflagging zeal" to obtain a recovery in what he calls "the main chance" and then criticises them in the next breath for failing to pursue clues "that *might* have led to a like recovery" in this case. (Tr. p. 71).

He states in his opinion (Tr. p. 61):

> "The newspapers carried accounts of the alleged civil and criminal liability of Farrington, some of which McBride had called to his attention, and there were *many suits* filed in court which contained positive allegations in relation thereto." (Emphasis ours.)

We assert, after careful scrutiny of the testimony in this case, that there is not one word of evidence therein that any suit except the suit of Brockie v. Farrington, et al, contained positive allegations in

relation to the civil and criminal liability of Farrington as *to the frauds here charged.* We have explained heretofore that the Brockie suit was dismissed at the motion of Brockie, and at his cost. Yet, Judge Fee does not remark on this phase.

Again, Judge Fee stated in his opinion that "In 1935, McBride knew of a tax claim asserted by the Internal Revenue Department". (Tr. p. 61). He then criticises McBride for not obtaining immediately a copy of the Revenue Agent's Report stating:

> "Thus he procrastinated for all these years in obtaining the copy although from his experience in tax matters, he must have known that this document would have been invaluable in unwinding the tangled skein which he had in his hands." (Tr. p. 62).

It is difficult to understand the logic of these remarks. Judge Fee must know that the method of assessing additional taxes by the Government is through a recommendation or report of an agent. But the mere fact that such a report is made followed by an assessment of additional tax in no way indicates that a charge of fraud is asserted. Not one case in a thousand of additional assessment cases arises through fraud. Usually it is because someone has omitted a profit made, or has improperly charged off a loss, or because a loss is taken in one year when it should have been taken in another, or because the tax payer felt he had an exemption when he did not. There are a thousand and one other reasons for addi-

tional assessments, and all additional assessments are based on recommendation of an agent contained in a report. Why, therefore, should Judge Fee surmise that McBride should be charged with a suspicion that the tax claim was based upon a report of an agent indicating fraud? There really can be no criticism of McBride for not obtaining a copy of the Agent's Report earlier than he did, and the animadversions of Judge Fee in this connection, we think, are unjustified.

As outlined in our Brief, this report was attempted to be obtained by McBride shortly after the Government filed a claim for taxes. McBride explained that when he went to the Referee and stated his intentions to file objections to the Government's claim the Referee with obvious propriety indicated that it would be unnecessary to file such claim until there was money in the estate on which the Government could realize in the event the claim was allowed. In other words, on the Referee's direction he took the practical means of postponing the filing of objections to the tax claim until there was money in the estate on which the Government could realize in the event the claim was allowed. Not until moneys came into the hands of the Court in a sufficient amount to pay all or a substantial part of the tax claim did there arise the occasion to contest the Government's claim. As soon as it arose the Trustee obtained the agent's report on which the tax was based. But Judge Fee

never comments on this phase of the matter in his opinion of some twelve printed pages.

Now again in connection with McBride's failure to obtain the Revenue Agent's report Judge Fee states, censoriously:

> "After he knew an income tax report existed, McBride called at the office of the agent of Internal Revenue but found no record there. Some time after this he found that Robert Jacob, an attorney, had a copy of this document. For three or four years after he had this knowledge he made no effort to see the report. Finally, he called at Jacob's office. He found that Jacob was out of the office and immediately abandoned all further effort." (Tr. p. 61, 62).

Now Mr. McBride testified as follows (Tr. p. 120):

> "Q. Then, as I understand you, the extent of your efforts to ascertain the basis of this claim of the Government for $50,000 was one visit to the office of the Internal Revenue Department in Portland and one visit to Bob Jacob's office, on which occasion you found him to be out of town?
>
> A. Yes. I do not remember any other times that I went after that. It was not coming up at that particular time, and the assessment that was made explained it enough to know how much they claimed, and there did not seem any necessity for going into it so much deeper until the claim was acted on before the Referee, so I did not go any further with it when I found that Mr.

Jacobs was not there, and I did not know he even had it."

Again, Judge Fee states (Tr. p. 67):

> "All the records of the bankrupt were placed in the Trustee's hands and he had some assistance and *sufficient money* to make an investigation of them."

Now the evidence introduced by the defendant shows (Ex. 111) that at no time prior to February 11, 1943, when the first monies were received from the Bank of California judgment, did the Trustee ever have more than $2400 at any time, and the testimony further shows that the accountant's bill for services in connection with the Bank of California matter alone was $2500. (Tr. 110). How, then, could Judge Fee find that the estate have sufficient monies on hand to make the investigations necessary?

We need continue no further.

## CONCLUSION

We firmly maintain that the District Court's judgment of dismissal should be reversed, since it held erroneously that the suit at bar was barred at any time previous to two years after the closing of the estate.

But if the Court were correct in that holding, we urge that it was certainly in error in holding that the Trustee was barred in his action based on the fraudu-

lent manipulations of the Consolidated Credit Company stock, since no intimation came to the Trustee of any nature in connection with that fraud.

Moreover, it is as firmly maintained that the Trustee's action was not barred by reason of any inactivity or failure to act in connection with the fraudulent appropriation of the Guaranty Company's stock, and that, therefore, the Court erred in holding to the contrary.

And it is further asserted that the Trustee's suit was not barred when there is taken into consideration the Trustee's lack of action (if any fault could be ascribed to him for such inaction) as against the appellee's fraudulent actions and manipulations. For failure to so distinguish, we urge, the Court was in error, and for this reason also, the judgment of dismissal should be reversed.

Respectfully submitted,

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